No. 10,253

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

SECTION SEVEN CORP. (a corporation),
Appellant,

vs.

CLIFFORD C. ANGLIM, Collector of Internal Revenue for the First District of California,
Appellee.

On Appeal from the District Court of the United States for the Northern District of California.

BRIEF FOR APPELLEE.

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BRIEF FOR APPELLEE.

OPINION BELOW.

The opinion of the District Court (R. 7-8) is not officially reported.

JURISDICTION.

This is an appeal from a judgment entered April 27, 1942, by the District Court. (R. 11-12.) The action arose under the internal revenue laws of the United States and is for recovery of capital stock taxes paid for the taxable period ended June 30, 1939, with legal

interest from the date of payment. The jurisdiction of the District Court was invoked under the provisions of Section 24, Twentieth, of the Judicial Code, as amended. The case is brought to this Court by notice of appeal filed July 18, 1942. (R. 12.) The jurisdiction of this Court in invoked under the provisions of Section 128 (a) of the Judicial Code.

QUESTION PRESENTED.

Whether taxpayer corporation was carrying on or doing business during the taxable period within the meaning of the applicable capital stock tax law, Section 601 of the Revenue Act of 1938.

STATUTE AND REGULATIONS INVOLVED.

Revenue Act of 1938, c. 289, 52 Stat. 447:

SEC. 601. CAPITAL STOCK TAX.

(a) For each year ending June 30, beginning with the year ending June 30, 1938, there is hereby imposed upon every domestic corporation with respect to carrying on or doing business for any part of such year an excise tax of $1 for each $1,000 of the adjusted declared value of its capital stock.

* * * * * * *

Treasury Regulations 64 (1938 ed.):

ART. 41. *Nature and rate of tax.*—The tax is an excise tax imposed with respect to carrying on or doing business during a taxable year ending

June 30, or any fractional part thereof. It is an excise tax upon the exercise of the privilege of doing business and not upon the business itself and is imposed upon each corporation with respect to carrying on or doing business and not upon each business carried on. If more than one corporation is engaged in carrying on a single business, each must file a return and pay the tax. The tax is imposed at the rate of $1 for each full $1,000 of the adjusted declared value of the capital stock. The tax may not be apportioned under any circumstances. If a corporation is engaged in business for any portion of a taxable year, liability for the tax is incurred for the entire taxable year.

ART. 42. *Doing business.*—The term "business" is very comprehensive and embraces whatever occupies the time, attention, or labor of men for profit. Accordingly, regardless of the nature of its activities, any corporation organized for profit and carrying out the purpose of its organization is doing business within the meaning of the Act. Similarly, even if not organized for profit, any corporation which engages in activities ordinarily carried on for profit is doing business. It is immaterial whether the activities result in a profit or a loss, or whether the corporation has been successful in its enterprise, or that because of unfavorable business conditions, no operations are carried on for a particular period. No particular amount of business need be done, nor is it necessary that the business be continuous throughout the taxable year.

The case is exceptional in which the activities of a corporation organized for profit do not amount to doing business within the meaning of

the Act. Such a case is generally limited to one in which the corporation is not pursuing the ends for which organized, i. e., profit.

ART. 43. *Illustrations.*—(a) *General.*—In general "doing business" includes any activities of a corporation whether it engages in—

(1) buying, selling, manufacturing, developing, financing, speculating, or otherwise dealing in or managing, property of any description;

* * * * * * *

(3) leasing or managing properties, collecting rents or royalties;

* * * * * * *

(7) leasing all its properties to another without divesting itself of all control and management of the properties under such terms that it keeps the properties in repair, or engages in other activities necessary to enable the lessee to utilize the leased properties, regardless of whether such activities are performed on behalf and under the order of the lessee or whether such acts are of major importance; or

(8) any other activities coming within the ordinary and natural signification of the term "carrying on or doing business".

(b) *Exceptions.*—Ordinarily the exceptions to "doing business" are restricted to limited activities of a corporation. For example—

(1) A corporation is not subject to the tax if its corporate powers are limited to the mere owning and holding of property and the distribution of its avails, or, although incorporated for the purpose of doing business, if it has retired from the business for which it was organized and has

reduced its activities to the mere ownership and holding of property, the distribution of its avails, and doing only such acts as are necessary to the maintenance of its corporate existence and the private management of its purely internal affairs. However, a corporation which has retired from its principal business is subject to the tax if, nevertheless, it engages in other business activities or maintains its organization for the purpose of continued effort in the pursuit of profit or gain.

STATEMENT.

This action was submitted upon oral and documentary evidence (R. 8) upon which the District Court made findings of fact and conclusions of law (R. 8-11). The facts as shown in the statement of evidence (R. 14-63), and the District Court's findings (R. 8-10), may be summarized as follows:

The appellant taxpayer corporation was incorporated under the laws of California in November, 1937, for the purpose of acquiring interests of tenants in common in Section 7, Township 20, Range 16 E., M. D. B. & M., Fresno County, California. (R. 9.)

In the year 1911, legal title to the property stood in the name of Mercantile Trust Company and subsequent to 1911, equitable title belonged to a number of different owners. (R. 14-15.) Prior to 1937, every member of a committee which had been appointed by the owners to direct the disposal of the property by Mercantile Trust Company had died. (R. 15.) Title to the property had become highly confused. (R. 15.)

In order to clear title to the property, it was necessary to bring a partition suit. (R. 15.) In 1937 a company offered to lease the property (R. 58) and the taxpayer was organized to take title to the property and make the lease (R. 15, 58). The taxpayer executed an oil lease on one-half of the property during 1937, although title to the property was not yet clear. (R. 58.) As a result of the partition suit, the property was partitioned in kind and the taxpayer corporation acquired five-sixths of Section 7 and one-sixth was partioned to an owner who did not convey his interest in the land to the corporation. (R. 59.) The private owners who transferred five-sixths of the property to the taxpayer received stock in the corporation therefor. (R. 59.) On June 3, 1938, a new lease was made covering the entire five-sixths of Section 7, acquired by the taxpayer. (R. 59.) A copy of the lease is set forth in full as "Plaintiff's Exhibit No. 1". (R. 16-45.)

Under the terms of the lease, the lessee, Seaboard Oil Company of Delaware, was granted the exclusive right to explore for, drill for, produce, treat, sell, etc., all oil and gas, asphaltum, and other hydrocarbons therein for a period of twenty years and for as long thereafter as oil, gas, etc. continued to be produced. (R. 9.) The lessee agreed to pay a royalty on all oil produced equal to $\frac{1}{6}$th of its value and a $\frac{1}{6}$th part of the net proceeds of all gas produced and sold. (R. 9.) The lease gave the lessor the option of receiving the oil royalties not in cash, but delivered in tanks on the leased premises provided that sixty days' notice of the exercise of the option was given. (R. 9.) The option

could be exercised once during the year, and in the absence of exercise, the lessee would pay the royalties in cash. (R. 9.) The lease provided that the possession by the lessee of the land should be exclusive, except that the lessor reserved the right to occupy the land or to lease it for agricultural, horticultural, or grazing uses, which should not interfere with the rights or operations of the lessee. (R. 18.)

The lessee agreed to commence drilling operations on the land within one year and to prosecute the same with reasonable diligence until oil or gas was found in paying quantities, or to a depth at which further drilling would be unprofitable. (R. 23.) It was provided that the lease should remain in effect if the lessee, within ninety days of abandoning drilling of any well, should commence drilling another. (R. 25.) It was further provided that if oil or gas was found in paying quantities in any well drilled by the lessee, that the lessee should continue to drill additional wells until there should be completed on said land as many wells as would equal the total acreage leased divided by twenty. (R. 24-25.) The lease provided that the lessee must drill off-set wells in the event producing wells were drilled on adjoining properties. (R. 28-30.)

The taxpayer, lessor, agreed to pay all taxes on the land as such and on its improvements and on its oil stored on the leased land and one-sixth of the taxes assessed against the petroleum mineral rights in the land then retained by the lessee. (R. 30-31.)

It was provided that the lessor may at all reasonable times examine the land, the work done and in progress

and the production therefrom, and may inspect the books kept by the lessee in relation to the production from the land, to ascertain the production and the amount saved and sold therefrom. The lessee agreed, on written request, to furnish the lessor copies of logs of all wells drilled by the lessee. (R. 31.)

It is provided that the lessor might terminate the lease for violation of any of its terms unless remedied within ninety days after written notice from the lessor so to do. (R. 33.)

Drilling was done pursuant to the terms of the lease and oil was found in September, 1938. (R. 10.) Oil continued to be produced, and by June 30, 1939, the taxpayer had received oil royalties amounting to $29,-409.29 and gas royalties amounting to $22.35. (R. 10.) The taxpayer, during the taxable period involved, received no other income save a nominal sum for rights of way given pursuant to the custom of the industry. (R. 10, 58.)

The option to take oil in kind, instead of cash royalties, has never been exercised by the taxpayer. (R. 57.) Cash royalties only were received. (R. 57.) The lessee forwarded to the taxpayer a statement of royalties, plus a check for the previous month's royalties on the twentieth day of the succeeding month. The royalty statement shows the amount of the production of oil and gas, the amount of the sales of oil and gas and the amount of royalties. (R. 57.) If the taxpayer desires, it may check or examine the actual production records. (R. 57.) The royalties received were distributed as dividends to the shareholders. (R. 56.)

The corporate activities of the taxpayer were exercised through its officers and board of directors. It had no regular employees. Its expenditures consisted of miscellaneous expenditures for telephone and office supplies, taxes, and fees of accountant and attorney. (R. 10.) For the taxable period ended June 30, 1939, the taxpayer's total income was $29,431.64 and its total expenses were $10,092.36. (R. 53.)

The taxpayer filed its capital stock tax return for the year ending June 30, 1939, and paid a tax of $1051. On November 18, 1939, a claim for refund was made on the ground that the taxpayer was not doing business during the year. The claim was rejected. (R. 10.)

Upon the above facts, the Court rendered the following conclusions of law (R. 10-11):

> (1) That plaintiff was doing business under the rule applied in *Kettleman Hills Syndicate v. Comm'r.*, 116 Fed. (2d) 382; *United States v. Trust No. B. I., 35, Etc.*, 107 Fed. (2d) 22.
>
> (2) That judgment should be entered for defendant, with costs.

SUMMARY OF ARGUMENT.

The taxpayer was carrying on or doing business within the meaning of the capital stock tax law. Its activities were within the literal wording of the Treasury Regulations which give as an illustration of a corporation doing business one that engages in "leasing or managing properties, collecting rents or royalties". The regulation is applicable and valid.

The lease entered into by this taxpayer had many conditions for continuance, such as requirements that new wells be drilled and that offset wells be drilled. To protect itself, the taxpayer must have seen to it that the conditions were met and engaged in business in doing so. The amounts of royalties must have been checked and that also would be a business activity. The decision as to whether royalties should be taken in cash or in oil was also a business activity.

ARGUMENT.

THE TAXPAYER WAS CARRYING ON BUSINESS WITHIN THE MEANING OF THE CAPITAL STOCK TAX LAW.

This Court considered the question of doing business for the purposes of the capital stock tax in the recent case of *United States v. Hercules Mining Co.*, 119 F. (2d) 288, certiorari denied, 308 U. S. 617, in which the corporation there involved was held liable. In that case it was said (pp. 290-291):

> The tax is assessed upon the privilege of doing business in a corporate capacity. What constitutes doing business? The courts have wrestled with the question many times but no formula has been deduced to fit all situations; and the decision in each case must necessarily hinge upon the particular facts. As defined in the leading case of *Von Baumbach v. Sargent Land Co.*, 242 U. S. 503, 37 S. Ct. 201, 204, 61 L. Ed. 460, the word "business" means "that which occupies the time, attention, and labor of men for the purpose of a livelihood or profit."

Regulations promulgated by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, under the several capital stock tax laws have attempted to show by illustrations the circumstances under which corporations are considered to be doing business or not to be doing business. Among the illustrations of a corporation doing business is Article 43 (a) (3) of Regulations 64 (1938 ed.), as follows: "leasing or managing properties, collecting rents or royalties;". This case obviously falls within the literal wording of the regulation. In the recent case of *Magruder v. Washington, B. & A. Realty Corp.*, 316 U. S. 69, decided April 13, 1942, the Supreme Court had under consideration the applicability and validity of another subsection of the regulations illustrating corporations doing business. It was held at pages 72-74:

> The regulation, Article 43 (a) (5), provides:
>
> "Art. 43. *Illustrations.*—(a) *General.*—In general 'doing business' includes any activities of a corporation whether it engages in——
>
> * * * * * * *
>
> "(5) the orderly liquidation of property by negotiating sales from time to time as opportunity and judgment dictate and distributing the proceeds as liquidation is effected—for example, the liquidation of an estate, or of properties taken over from another corporation, or of the shareholders' fractional interests in particular property;"
>
> If the regulation is both applicable and valid, respondent manifestly cannot prevail.

On the question of applicability there can be no doubt, for the language of the regulation precisely describes respondent's activities. We find without substance respondent's assertions that Article 43 (b) (2) is inconsistent with Article 43 (a) (5) and that it more exactly fits the facts of this case. During the period in question, respondent not fall into that state of quietude, covered by the specific language of Article 43 (b) (2), in which it was merely owning and holding specific property and distributing the resulting proceeds. See *Zonne v. Minneapolis Syndicate,* 220 U. S. 187; cf. *Von Baumbach v. Sargent Land Co.,* 242 U. S. 503, 516-17. On the contrary, respondent was actively engaged in fulfilling the purpose of its creation, the liquidation of its holdings for the best obtainable price.

Article 43 (a) (5) is both a contemporary and a long standing administrative interpretation, having been in effect in substantially the same form since 1918, except for the period from 1926 to 1933 when the tax was not imposed. We are of opinion that it is valid, as well as applicable. The crucial words of the statute, "carrying on or doing business," are not so easy of application to varying facts that they leave no room for administrative interpretation or elucidation. To be sure, in many, if not in most instances, the factual situation will be so extreme as to leave no doubt whether a corporation is doing business or not. But the nuances of facts between the two extremes have produced a nebulous field of confusion which has been recognized by courts striving to fit close cases into one category or the other. Interpretative regulations, such as Article

> 43 (a) (5), are appropriate aids toward eliminating that confusion and uncertainty. Cf. *Helvering v. Wilshire Oil Co.,* 308 U. S. 90, 102; *Textile Mills Securities Corp. v. Commissioner,* 314 U. S. 326.

It would seem that the same reasoning is applicable to the present case and the regulation should be held applicable and valid, although the exact wording of Article 43 (a) (3) is not found in the regulations pertaining to the capital stock tax earlier than the 1936 edition.

Aside from the regulation, it would seem that this taxpayer's activities were such as to constitute doing business as business is generally conceived. Of course, it is established law that a corporation which leases all of its property for a long term and surrenders all control over it to the tenant and merely collects and distributes the rentals is not taxable as a corporation doing business. *Zonne v. Minneapolis Syndicate,* 220 U. S. 187; *United States v. Emery,* 237 U. S. 28. But in such cases the amounts of rental were fixed, the leases were for definite long periods and the lessees were not required to improve, develop or exploit the properties. Here the term of the lease was hedged about by many conditions such as the requirements of continuous new well drilling, the drilling of offset wells, etc. To protect itself the taxpayer must have seen to it that the conditions were fulfilled and that, we believe, is a business activity. Likewise, the taxpayer must have used some diligence in verifying the

correctness of the royalties received, again a business activity. Speaking of a somewhat similar situation, this Court held in the case of *United States v. Trust No. B. I., 35, Etc.,* 107 F. (2d) 22, at page 24:

> Each of the leases shaped the duties of the tenant with respect to the development and exploitation of the petroleum deposits. They required wells to be drilled in the lessor's land until a certain number was reached, and for their care and continued pumping as long as the oil therefrom was saleable, above a minimum fixed price.
>
> Obviously, in making leases with such requirements from its lessees, the owner of the land is engaged in a creative enterprise for profit, just as it is engaged in such a creative enterprise when it stores, settles and transports the oil to its buyers.

With respect to the taxpayer's option to take royalties either in oil or cash as constituting doing business, the following quotation from this Court's opinion in the case of *Kettleman Hills R. S. No. 1 v. Commissioner,* 116 F. (2d) 382, at page 383, is pertinent:

> It is thus apparent that the taxpayer has to make the business judgment from time to time concerning the existing continuing production, whether it will be more profitable for the enterprise to exercise one or the other of the options to receive payment (a) in the form of oil, gas or gasoline or (b) in cash. The trust declaration provides that in order that taxpayer "may dispose of" these petroleum products when received in kind it may make "promissory notes" and "evidences of indebtedness * * * necessary in their

judgment to protect or take advantage" of their acquisition. That is to say, the trust contemplates the taxpayer might store and process the oil, gas or gasoline and dispose of them as was done in *Trust No. B. I. 35, supra,* and gives it in detail the power so to do.

It is our opinion that in making these successive decisions whether it will require the delivery of the royalty product in kind or in cash, the taxpayer is making a succession of business judgments and "is doing business" within the decision of *Morrissey v. Commissioner,* 296 U. S. 344, 360, 56 S. Ct. 289, 80 L. Ed. 263, though through the tax years in question it thought it better business to accept cash rather than the oil products.

Concededly, this taxpayer's activities during the taxable period were not great, but that is not the test. If *any* activities of a business nature are engaged in for profit the tax applies. *Flint v. Stone Tracy Co.,* 220 U. S. 107; *Von Baumbach v. Sargent Land Co.,* 242 U. S. 503; *Harmar Coal Co. v. Heiner,* 34 F. (2d) 725 (C. C. A. 3d), certiorari denied, 280 U. S. 610. Viewed as a whole, we submit that the situation and activities of this taxpayer constituted doing business.

CONCLUSION.

The decision of the District Court was correct and should be affirmed.

Dated, December 7, 1942.

Respectfully submitted,

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